The pros and cons of sleeping SLLs

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05:35

Video transcript

Amanda Balasubramanian (00:05): Sustainability-linked loans have surged in popularity over the past few years. Known as SLLs, these are loans where an economic outcome, such as a reduction in interest or fees, is linked to the borrower's performance of meaningful sustainability objectives. Against this backdrop, we're seeing the growth of so-called sleeping sustainability-linked loans. A sleeping SLL is essentially a conventional loan agreement that contains provisions, which allow the borrower to set key performance indicators and sustainability performance targets after the closing date. They're referred to as "sleeping" because the sustainability aspect of the loan is delayed and activated at a later date. I'm Amanda Balasubramanian, co-head of the debt finance practice at Torys, and I'm here with my partner, Jon Wiener, from our New York office, to discuss the pros and cons of sleeping SLLs. Jon, why is it that we're seeing sleeping SLLs in the market?

Jonathan Wiener (01:04): The reality is that borrowers sometimes require capital before they are ready to establish meaningful sustainability KPIs or key performance indicators. Many borrowers would ideally like to set those targets from the start, but their ESG maturity level doesn't allow them to do that. Setting KPIs requires a lot of upfront work, particularly for a company that doesn't have a fully developed ESG infrastructure in place.

That's because KPIs need to be credible. They need to both be material to the borrower's business and ESG strategy, and capable of being measured and benchmarked going forward on a regular basis. These realities often leave borrowers with a difficult choice. Either they execute an SLL now, but with less meaningful "or quantifiable targets (or potentially risk accusations of greenwashing if they rush and get things wrong), or they pursue a sleeping SLL with provisions that will be delayed but could be more meaningful. If the market thinks SLLs are positive and encourage better ESG behaviour from borrowers, then sleeping SLLs represent a way to encourage more borrowers to join in when they are ready to get it right. But sleeping SLLs have also received some criticism.

Amanda Balasubramanian (02:29): Yes. The issue is that a loan is not a sustainability-linked loan until the KPIs and the SBTs have been set, and the other requirements of the sustainability-linked loan principles have been reflected in the documentation. Even if the borrower fully intends to set those immediately after closing, the loan is still not considered an SLL until that happens. As a result, any marketing or disclosure about a sleeping SLL runs the risk of misleading the market if it is labelled as "sustainable".

Transparency is so important for sustainability-linked loans as it is for all ESG initiatives. SLLs that are not legitimate could be considered greenwashing, undermining the credibility of the parties and the SLL market. The key is for no misrepresentation to be made by the borrower or the lenders, with respect to the nature of a sleeping SLL.

Jonathan Wiener (03:23): It does sound like the market is trying to find the right balance here. One interesting step in that direction was the LSTA guidance on sustainability-linked loan principles. On the one hand, the guidance provides more flexibility to borrowers by allowing sustainability targets to be set later with just a majority or required lender approval, which is meaningful as changes that affect pricing of a credit facility would typically need unanimous lender consent.

On the other hand, the guidance looks to build credibility in SLL products by clarifying that sleeping SLLs are only treated as SLLs when the KPIs are actually established and approved by the required lenders. The guidance suggests that sleeping SLLs should only be used for extraordinary circumstances and that the required lender approval of the KPIs should occur within one year of the closing date.

I would argue that the market is better served by having more sleeping SLLs and not just relegating this idea to extraordinary circumstances, and think that the one year limit is arbitrary. In any event, even without sleeping SLL architecture, any loan agreement can be amended to become an SLL post-closing with unanimous lender consent, and lenders are generally eager to hold SLL and other ESG loans, so that may not be a difficult consent to obtain. It's interesting to note that the LMA guidance from the English equivalent of the LSTA does not provide for sleeping SLLs, so others in the industry are clearly more skeptical.

Amanda Balasubramanian (05:10): It's a challenging balance to strike, and we welcome the efforts of the organizations behind the sustainability-linked loan principles and their related guidance to deal with key issues in the market. We expect the demand for SLLs to increase and the market to mature around both sleeping SLLs and SLLs in general.

As sustainability-linked loans surge in popularity, some borrowers and lenders are easing into this financing option with "sleeping" sustainability-linked loans. Under this mechanism, borrowers are allowed to set their sustainability goals after the closing date.

In this video, Toronto partner Amanda Balasubramanian and New York partner Jonathan Wiener explain the pros and cons of sleeping SLLs to help borrowers assess this option as part of their financing strategy.

You'll learn:

- Why many borrowers and lenders have pursued sleeping SLLs
- How sleeping SLLs work in practice
- How market players are responding
- What the Loan Syndications and Trading Association recommends

To discuss these issues, please contact the author(s).

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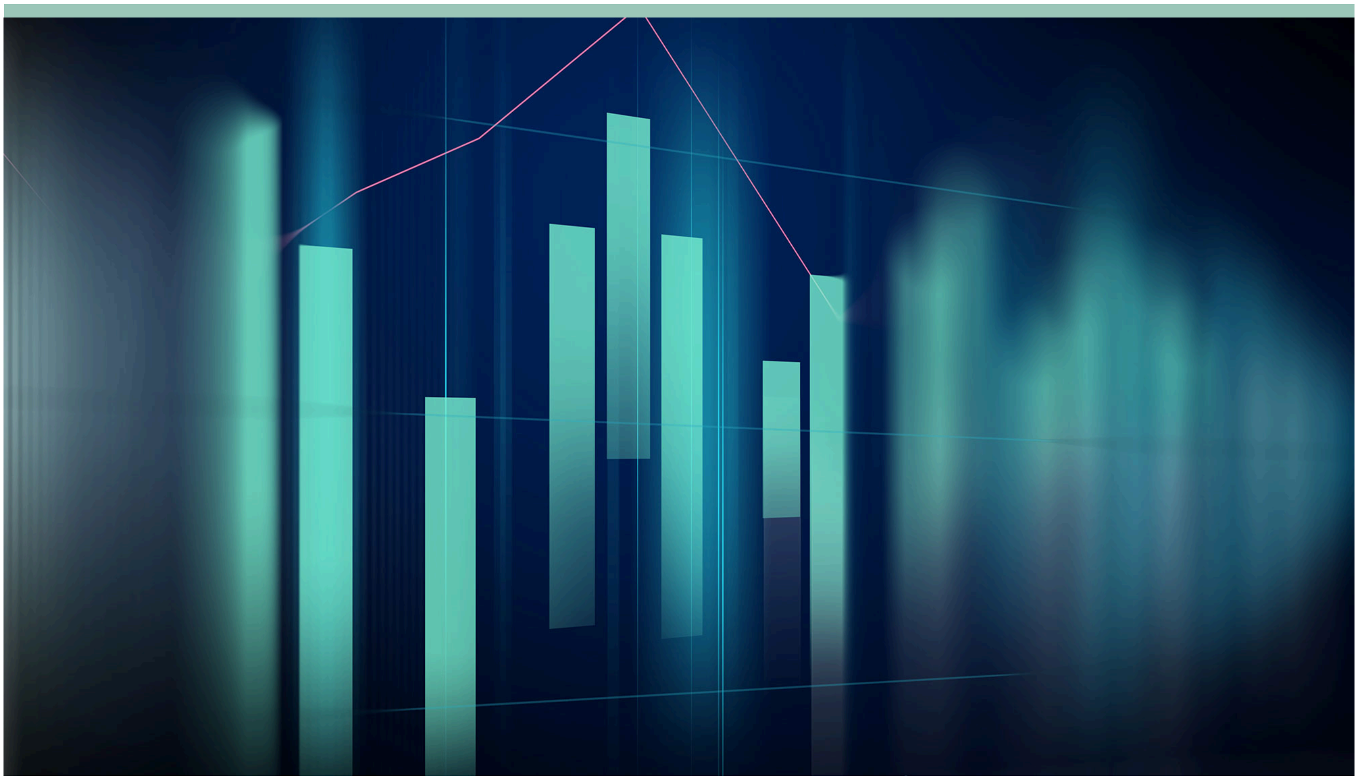

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